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KPIs AND REPORTING UNDER IFRS 16

JULY 2019

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INTRODUCTION

- IFRS 16, the new accounting standard on leases, was adopted on 1 January 2019; this paper gives an overview of the Standard and explains its impact on the accounting and KPIs of the Group.

- This paper also includes brief updates on the following:
  - Definition of Adjusted Earnings
  - Useful Economic Life of gym equipment
  - Financial impact on the implementation of the new model for personal trainers ("New Gym Team")
  - Definition of 'mature gym' for 2019

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INTRODUCTION AND KEY PRINCIPLES OF IFRS 16

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WHAT IS IFRS 16?

- New accounting standard governing lease accounting
- Replaces old lease accounting standard IAS 17
- Changes the accounting treatment for all of our property leases
- Mandatory application for all periods commencing on or after 1 January 2019
- The financial impact of the transition to IFRS 16 is disclosed in detail in the 2018 Annual Report
- The 2019 half-year results will be under IFRS 16 and financial results for the year ended 31 December 2018 are required to be restated for ease of comparison

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IAS 17 VS. IFRS GENERAL PRINCIPLES

THE OLD - IAS 17

- Assets under operating lease are not shown in the balance sheet; they are simply disclosed off-balance sheet as operating lease commitments.
- Total amount payable under an operating lease is recognised on a straight line basis in the income statement (i.e. total payments divided by the length of the lease = annual rent expense).
- Group Adjusted EBITDA includes this rent expense.
- The balance sheet includes a liability for the 'smoothing effect' of the income statement charge (i.e. timing difference between cash payment and income statement rent expense). This often arises for example from an initial rent-free period.

THE NEW - IFRS 16

- The presentation of leased assets has been more closely aligned to that of owned assets.
- The hurdle for on-balance sheet recognition has been lowered from "control" to "right of use".
- On inception, a lease is recognised on the balance sheet as a finance lease liability and right of use asset, calculated as the present value of future payments.
- EBITDA no longer includes a rent expense.
- Instead, profit before tax includes an interest charge on the finance lease liability and a depreciation charge on the right of use asset.
- There are some exceptions to this treatment, but they are not material to the Group.

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OUR PROCESS TO ADOPTION

Our choice of approach

- Two options available for IFRS 16 adoption:
  - Fully retrospective (as if IFRS 16 had always applied); or
  - Modified retrospective (as if all leases commenced at the date of adoption).
- Elected to use a fully retrospective approach, due to the financial significance of the Standard on the Group results.
- Comparative year (2018) financial result will be fully restated in the 2019 Annual Report.

Our process

- All arrangements within the scope of IFRS 16 were assessed, with a comprehensive and thorough review of every individual lease contract, including each of the 158 gym leases as at 31 December 2018.
- Recalculation of lease financials dating back to the signing of the very first lease in Hounslow in 2007, based on the contractual clauses and historical market inputs, including an estimate of the Incremental Borrowing Rate as would have applied at that time.
- Recalculation of historical group reorganisation based on the IFRS 16 financials as they would have been in 2013.

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IMPACT ON OUR FINANCIAL STATEMENTS

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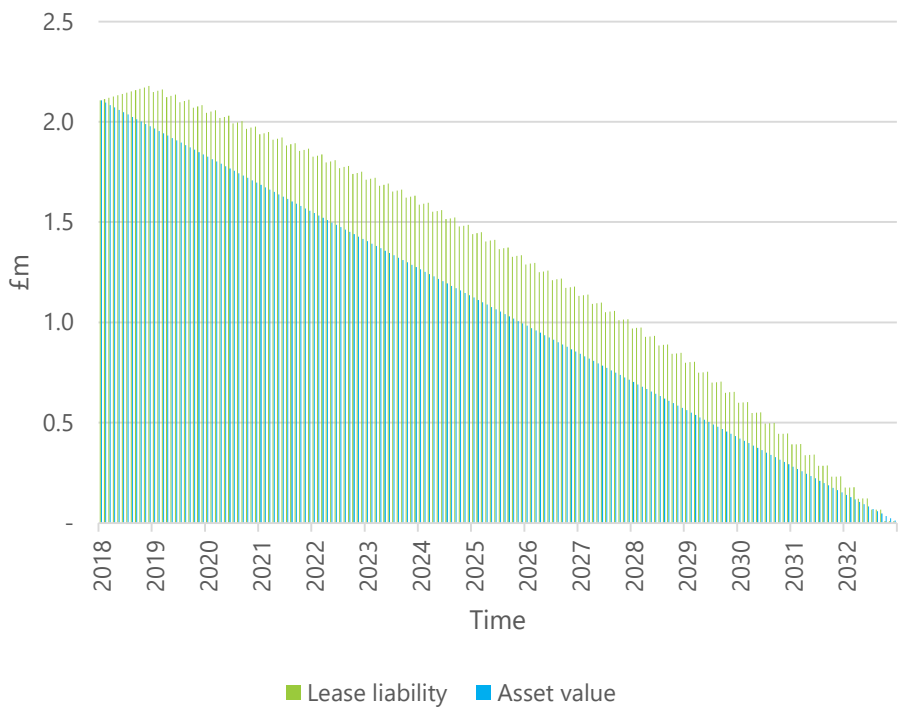
BALANCE SHEET PROGRESSION UNDER IFRS 16

SINGLE SITE EXAMPLE

- At inception, the lease liability equals the asset value, and at the end of the lease, they are both nil. However, their values differ over the life of each property lease.
- The right of use property asset depreciates evenly on a straight line basis, subject to annual impairment testing.
- However, the lease liability changes by the net of interest charged and payments made.
- Since there is often a rent-free period at the start of a new lease, the lease liability will increase as interest accrues until the first payment is made. The liability will then decline ever more rapidly as the interest charge portion of each payment decreases over time.



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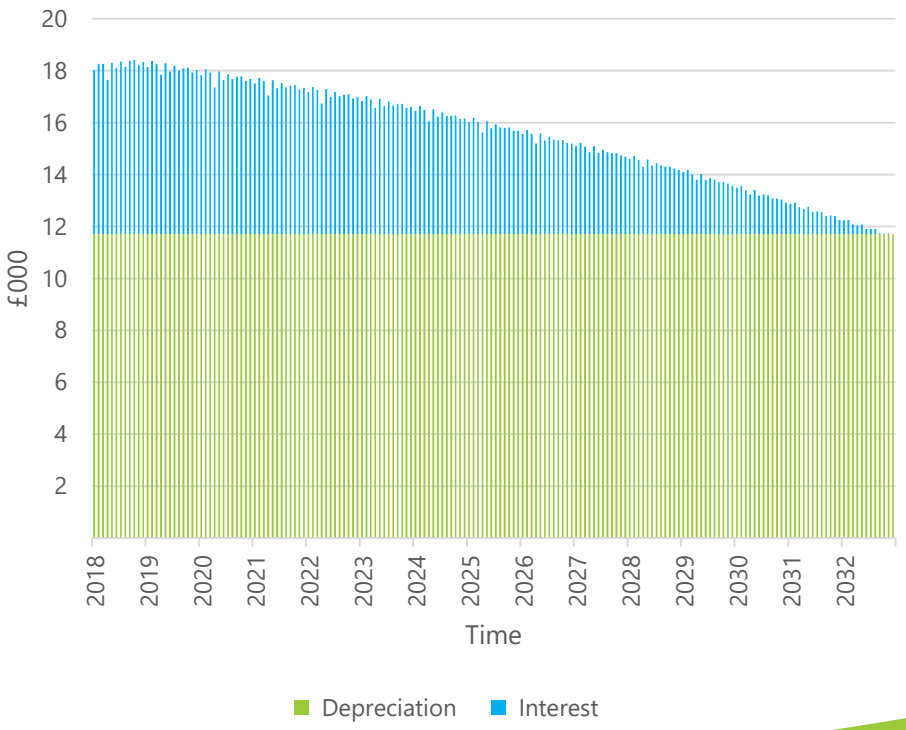
INCOME PROGRESSION UNDER IFRS 16

SINGLE SITE EXAMPLE

- In place of the old straight-line rent expense over the life of the lease, IFRS 16 sees an initial peak in income statement charge whilst interest charge is at its highest.
- This tails off to a low point in expense at the end of the lease.
- Despite these changes, there is no change to cash or total income statement charge; the total income statement charge over the life a lease will remain equal to the total cash over the life of that lease.
- However, there are significant changes to certain key measures as seen on the following pages.



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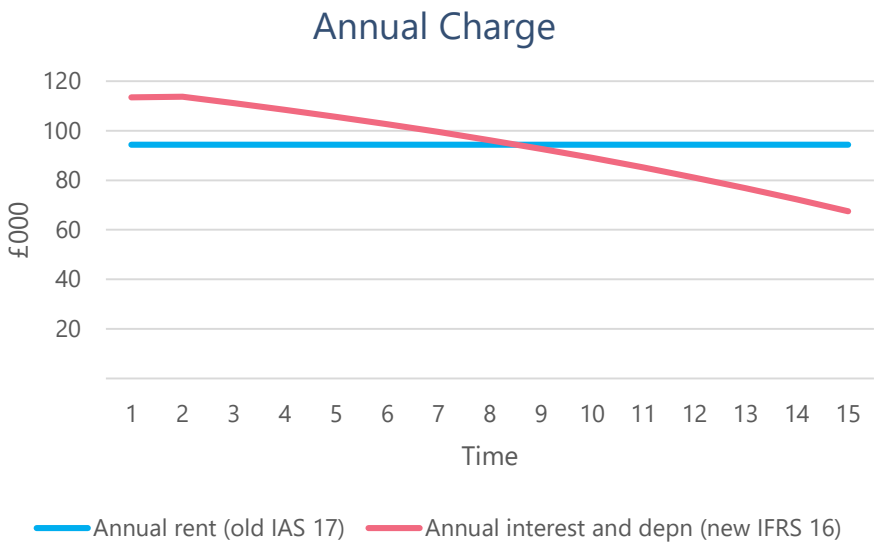
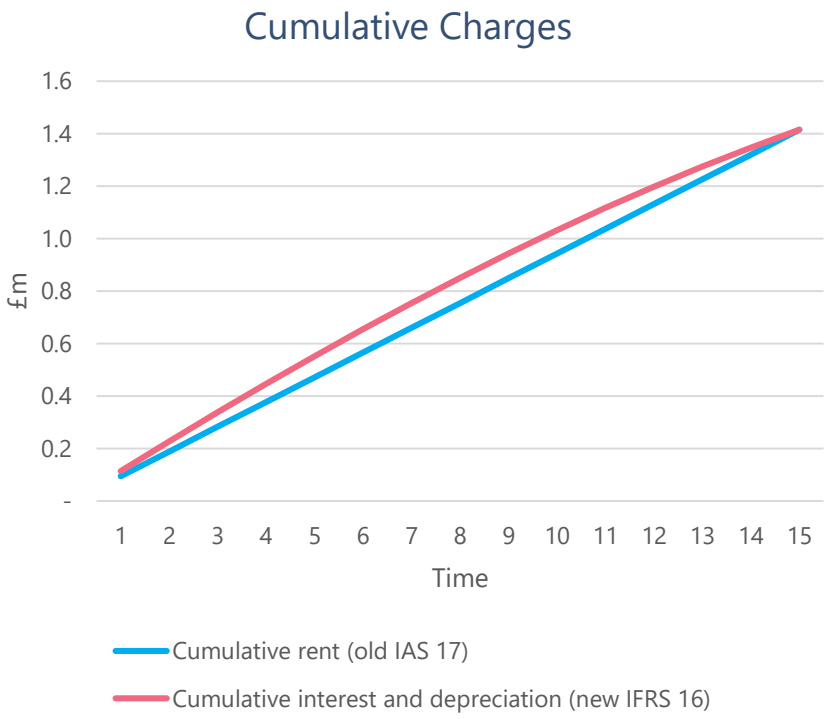
INCOME – OLD TO NEW

SINGLE SITE EXAMPLE





- The annual impact on PBT and EPS depends on lease maturity; IFRS 16 is dilutive at the beginning of a lease, and accretive at the end of a lease. The overall effect of IFRS 16 on the Group depends on the specifics of each individual lease agreement and the mix of lease maturity.

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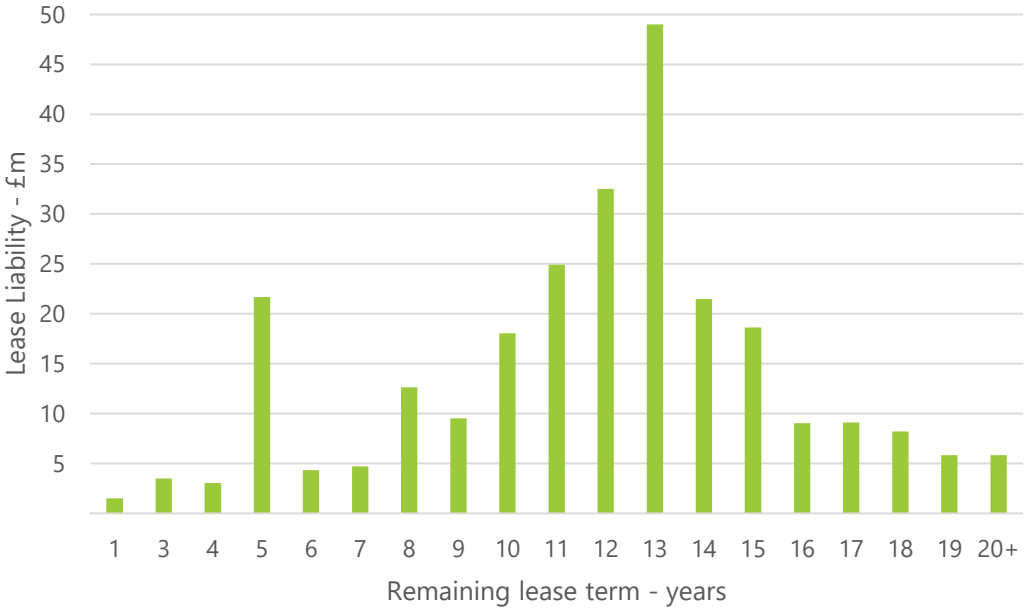
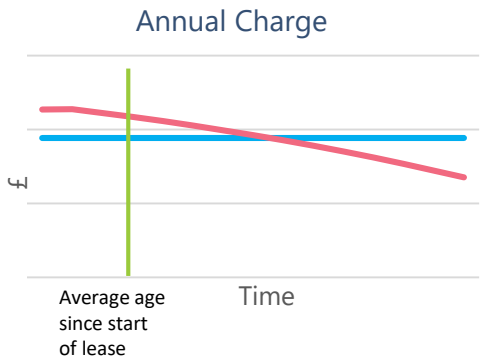
LEASE PORTFOLIO OVERVIEW

- Our lease portfolio is relatively immature.
- As at 31 December 2018, average full term is 16.7 years.





As the average age of our leases is relatively young, our annual charge is at this point in time higher under IFRS 16 (red line) than was under IAS 17 (blue line).

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LEASE MOVING ON BALANCE SHEET

New lease assets:

- Our leases previously disclosed as off balance sheet commitments in our annual report (2018 extract below):

Operating lease commitments

The Group has entered into leases on commercial real estate. These leases have an average outstanding life of 12.7 years (2017: 14.1 years) with no renewal option included in the contracts. There are no restrictions placed on the Group by entering into these leases.

Future minimum rentals payable under non-cancellable operating leases as at 31 December, analysed by the period in which they fall due, are as follows:

	2018 £'000	2017 £'000
Within one year	**24,546**	18,634
Between one and two years	**25,345**	20,225
Between two and five years	**103,676**	62,296
Greater than five years	**186,240**	191,906
	339,807	293,061

- Under IFRS 16, this translates to a new lease liability of £243.0m onto the balance sheet at 31 December 2018.
- The reduction in value is due to the lease-by-lease discounting of payments under IFRS 16.
- The weighted average Incremental Borrowing Rate ('IBR') across all leases is 4.8%. This varies between 3.5% and 8.7% for each individual lease, depending on the start date and term.

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BALANCE SHEET AS AT 31 DECEMBER 2018

Footnotes:

(1) 'Lease incentive liability' represents the rent expense recognised under IAS 17 during rent-free periods but not yet paid.

(2) 'Additional acquisition goodwill' represents the recalculation on an IFRS 16 basis of goodwill arising in the 2013 group reorganisation, due to the additional lease liability created.

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INCOME FOR FY2018

	Before IFRS 16	Exclude rent	Include depreciation	Include interest	Other	After IFRS 16	
Revenue	123.9					123.9	No impact
Operating lease rentals	(21.7)	21.7				-	Exclude operating lease rentals
Depreciation	(19.7)		(14.8)			(34.5)	Include straight-line depreciation on leased assets
Other operating costs	(70.8)				0.1	(70.7)	Adjustment to acquired contract asset value
Operating profit	**11.7**	**21.7**	**(14.8)**	**-**	**0.1**	**18.7**	
Finance costs	(1.7)			(10.9)		(12.6)	Include finance lease interest, relatively high due to lease immaturity
PBT	**10.0**	**21.7**	**(14.8)**	**(10.9)**	**0.1**	**6.1**	
Adjusted PBT	**14.3**	**21.7**	**(14.8)**	**(10.9)**		**10.3**	
Adjusted Earnings	**11.2**	**21.7**	**(14.8)**	**(10.9)**	**0.7**	**7.9**	Including a tax credit of £0.7m from higher income statement costs under IFRS 16

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CASH FLOW FOR FY2018

IMPACT IS ONLY PRESENTATIONAL:

£m	Before IFRS 16	Rent reclassified to interest and debt repayment	Rent-free period reclassified to debt phasing	After IFRS 16	
Group adjusted EBITDA	36.8	21.7	-	58.5	Exclude operating lease rentals
Movement in working capital	5.5	-	(2.2)	3.3	Reclassify movement in rent-free accrual to financing cash flow
Maintenance capex	(8.3)	-		(8.3)	No change
Group operating cash flow	**34.0**	**(21.7)**	**(2.2)**	**53.5**	
Cash flows from financing activities:					
Finance lease payments	-	(21.7)	2.2	(19.5)	Reclassification from operating cash flow
Net cash flow	**2.6**	**-**		**2.6**	No change

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IMPACT ON KPIS FOR 2018 (BEFORE REVISIONS)

	Before IFRS 16	After IFRS 16	Change	
Revenue	£123.9m	£123.9m	-	No impact
Group adjusted EBITDA	£36.8m	£ 58.5m	£21.7m	Exclusion of rent
Group operating cash flow	£34.0m	£53.5m	£19.5m	Exclusion of rent, plus movement in rent-free period reclassified to financing
Net cash flow	£2.6m	£2.6m	-	No impact
Net debt	£46.0m	£289.0m	£(243.0)m	New finance lease liability
Adjusted earnings per share	8.4p	5.9p	(2.5)p	Depreciation and interest are higher than the rent they replace, driven by the relative immaturity of the lease portfolio
ROCE	31%	20%	(11)%	111% increase in capital employed outweighs 36% increase in EBITDA
Mature site EBITDA margin	45.3%	61.8%	16.5%	Exclusion of rent
Net debt to Group adjusted EBITDA	1.25x	4.94x	3.69x	The addition of the finance lease liability causes Net debt to increase by a larger proportion than the effect of excluding rent from Group adjusted EBITDA.

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REVISIONS TO KPI DEFINITIONS

- As can be seen from the previous slide, several of the KPIs by which we run the business and report progress externally will be significantly affected by the introduction of IFRS16.
- However, as IFRS 16 has no impact on Group strategy or cash, we have reassessed our KPIs, the aim being to have useful KPIs that best measure the underlying performance of the business.
- The new KPI definitions, as can be seen on the next page, are more closely aligned to actual cash returns. The benefit of this is that they are unaffected by metrics such as average lease maturity and the contractual approach to rent increases (RPI-based vs fixed increases) that are not a reflection of business performance but that do have a significant impact on some of the current metrics under IFRS 16.
- In the development of these new KPIs we have consulted with external advisors and reviewed them in detail with our Board. We believe they represent suitable metrics by which we should measure performance internally and provide updates to external stakeholders

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REVISED KPI DEFINITIONS

Current KPI	Pre IFRS 16 (2018)	Post IFRS 16 (2018)	New KPI	New KPI definition	New KPI (*) (2018)
Group adjusted EBITDA	£36.8m	£58.5m	Group adjusted EBITDA	IFRS16 EBITDA minus cash rent costs	£39.0m
Group operating cash flow	£34.0m	£53.5m	Group operating cash flow	IFRS16 operating cash flow minus cash rent costs	£34.0m
Net debt	£46.0m	£289.0m	Non-property net debt	IFRS16 net debt minus property finance leases	£46.0m
Mature site ROCE	31%	20%	Mature site ROIC	Return on Invested Capital: Adjusted EBITDA (as defined above) divided by initial cash invested	30%

(*) Note that the New KPIs are not impacted by IFRS 16, and are therefore the same values both pre- and post-IFRS 16.

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OTHER MATTERS

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GYM EQUIPMENT USEFUL ECONOMIC LIFE

- The Useful Economic Life (‘UEL’) of gym equipment was last updated in 2017, when the UEL for cardio equipment was increased from 5 to 5½ years and strength equipment from 7 to 8 years.
- However, we now have a weight of evidence from across our estate that, supported by our rigorous maintenance regime, both cardio and strength equipment is lasting significantly longer than this.
- Therefore from 1 January 2019, the UEL for Cardio and Strength equipment was increased to 7 and 9 years respectively.

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ADJUSTED EARNINGS DEFINITION

- Adjusted earnings per share has to date included an adjustment to remove amortisation, on the basis that the majority of it related to acquired intangibles (brand, customer lists, contracts).
- However, as the business has grown, the investment in software has increased, as has the associated amortisation of the intangible software asset.
- From 2019, we will therefore no longer adjust for amortisation of software within Adjusted EPS.
- For 2018, £1.0m of software amortisation would be added back. For 2019, we expect the decrease in depreciation charge from the change of UEL (see previous page) to offset most, but not all, of the impact of this change in the definition of amortisation.

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NEW GYM TEAM: FINANCIAL IMPACT

The financial impact in 2019 of the new model for personal trainers ("New Gym Team") is forecast to be as follows:

- Revenue (rental income from Personal Trainers): increase of £4m
- Cost (salary and related costs for Personal Trainers): increase of £5m
- EBITDA: decrease of £1m (as previously guided)

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MATURE GYM DEFINITION FOR 2019

- For 2019, mature gyms will be defined as all organic openings on or before 31 December 2017.
- This totals 110 gyms (prior year: 89).
- To confirm, mature gyms will therefore exclude:
  - Organic openings in 2018 (17 gyms) and 2019 (TBC)
  - All acquired easyGym sites (13)
  - All acquired Lifestyle sites (18)
- All easyGym and Lifestyle sites will be mature from 2020.

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THANK YOU

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